TEACHERS' RETIREMENT BOARD

REGULAR MEETING

SUBJECT: Health Benefit Funding Mechanism | ITEM NUMBER: 9

ATTACHMENT(S): 1

ACTION: X | MEETING DATE: June 8, 2000

INFORMATION: ___ | PRESENTER: Ed Derman

SUMMARY

In evaluating the provision of health benefits to members of the California State Teachers' Retirement System (CalSTRS), the Teachers' Retirement Board (Board) has to consider two issues: (1) what health care benefits to provide and (2) how those benefits should be financed. The Board has previously discussed the types of health care benefits that could be provided. This item discusses how health care benefits could be financed.

There are essentially three different approaches to financing health care benefits for CalSTRS members. They are

- Funding benefits directly from the Teachers' Retirement Fund (TRF)
- Funding benefits from contributions to a special health care benefit trust fund and
- Funding benefits from reductions in employer contributions.

Funding from the Teachers' Retirement Fund

Currently, benefits paid to retired members of the Defined Benefit (DB) Program are paid from the TRF, which is financed from a combination of member, employer and General Fund contributions, and the proceeds from investing those funds. Federal law, however, substantially limits the authority of a retirement system to use assets of a retirement plan, such as the DB Program, to provide health care benefits for plan members, even if the assets of the plan exceed plan liabilities. Essentially, in order to use TRF money directly to fund health care benefits, the DB Program must have assets that are at least 125 percent of plan liabilities, and all members of the program must be vested. In addition, these assets could only be used to fund health care benefits for retired members, and not active members.

This last restriction is consistent with the direction the Board has been taking with respect to health care benefits. However, although current assets exceed current liabilities, assets are less than 125 percent of liabilities. In addition, members currently must have at least five years of credited service to be eligible for retirement benefits. If the provisions of the DB Program were modified to vest all current liabilities, the liabilities of the DB Program would increase significantly, and the remaining DB Program resources would be available for health care benefits reduced if not eliminate entirely.

One means by which TRF funds could be used is to increase allowance payments to all or selected retired members of the DB Program. This increased allowance would then be available to the member to pay the health benefit care costs directly. For example, with respect to making Medicare Part A benefits available to members who are not eligible for premium-free Part A, the allowance of such members could be increased by the amount of the premium, and the member could buy the premium from the Health Care Financing Administration.

Increasing allowances as a means of financing health care benefits has two significant drawbacks. First, the increase in allowances would increase the taxable income of the member. If the amount of the increase to the member were limited to the premium for the benefit, the member would incur increased out-of-pockets costs to pay the increase income taxes. Alternatively, the amount paid in the higher allowance could include an amount to pay the higher income tax. This, however, would increase the cost of the benefit to the program.

The second drawback is that there is no guarantee that the member would use the increased allowance to purchase the health care benefit. Although the member would, presumably, be using the funds to his or her own perceived best advantage, if the increased allowance was used for some other purpose, the Board's objective of providing health care benefits would not be realized.

Funding from Contributions to a Health Care Fund

The second means to finance health care benefits is to establish a separate fund to pay the cost of health care, and impose contributions that are deposited in that fund. This is consistent with how the TRF is funded. The money in the fund would be restricted to the provision of whatever health care benefits are authorized in statute. As a result, the Board would have greater assurance that the objectives of the program are being met.

Contributions from the traditional sources of TRF contributions (members, employers or the General Fund) could be increased to finance this health care fund. Although this would provide a revenue stream for health care benefits independent of any other CalSTRS program, increasing net contributions would increase costs to the affected parties. Because the DB Program has substantial resources available to it that exceeds current and future liabilities, these available resources could be used to indirectly pay the contributions to the health care fund, in a manner consistent with the current federal restrictions on the use of surplus retirement funds, and avoid any additional impact on members, employers or the General Fund.

In this approach, the contribution rate to the DB Program would be reduced by a specific amount, and the contribution rate to the health care fund would be increased by the same amount, resulting in no net increase to any of the entities that contribute to the DB Program. As a result, contributions that otherwise would be credited to the DB Program would be intercepted before they are credited to the DB Program, and deposited into the separate health care fund. If the present value of the contribution rate diverted from the DB Program did not exceed the available resources, such a diversion would not undermine the funding status of the DB Program, as long as the experience of the DB Program was consistent with the program's actuarial assumptions. The impact of the diverted contributions on the DB Program would be offset by the availability either of the normal cost surplus or the actuarial surplus. As a result, the DB Program would be, in effect, financing the cost of the health care benefit.

There is precedent for using such an intercept method, both nationally and within the DB Program to finance special retirement benefits, and by other California pension plan to finance health benefits. Section 415 of the Internal Revenue Code limits the annual dollar amount of allowances payable by the DB Program to an individual member, even if the member made sufficient contributions in order to finance the entire allowance. As a means of financing the benefits payable to DB Program members in a manner that complies with Section 415, legislation was enacted last year that requires CalSTRS to intercept employer contributions before they are credited to the DB Program, and use those intercepted contributions to pay the allowance that exceeds the Section 415 limit. Because the DB Program received enough contributions from the member and the employer to finance that higher allowance, the DB Program will not experience an actuarial loss by having those contributions intercepted. The Internal Revenue Service (IRS), in a private letter ruling to another statewide plan, has approved this method to finance this retirement allowance.

According to the attached report from William M. Mercer, Incorporated, at least six California public retirement systems intercept contributions as a means of financing health care benefits, using available retirement plan surpluses to backfill the loss of future retirement plan income. In addition, the IRS has informally approved this method as a means of financing health care benefits for retired members.

The drawback to the intercept approach is that, if long-term economic conditions should change, the availability of resources in the DB Program to offset the foregone contributions could decline. At that point, either total contributions to the DB Program and the health care program would have to increase, or program liabilities would have to be reduced. The design and the funding of the health care benefits program should consider the need to develop sufficient reserves in the health care benefit fund, in order to be able to continue to provide health care benefits if future contributions to that fund have to be reduced for a period of time.

Funding from Reduction in Employer Contributions

A third alternative is to reduce contributions made to the DB Program by those employers who provide one or more health benefits specified in statute to their retired employees. For example, if an employer provided health benefits at least comparable to that provided by Medicare, that employer's contribution could be reduced by the amount spent on retired members not otherwise eligible for Medicare. This would avoid the need for CalSTRS to establish a separate fund for health care benefits. However, the available resources in the DB Program would effectively pay for the health care benefits, because future contributions to the DB Program would be reduced, and the available resources would backfill the foregone contributions.

There are, however, a couple of significant disadvantages to this approach. First, although CalSTRS would avoid the need to establish a system to administer health benefits directly, CalSTRS would have to monitor the extent to which employers are providing the health care benefits required as a condition of realizing the reduction in contributions. In addition, if the reduction in contributions was limited to the cost incurred by the employer to provide those benefits, employers who do not currently provide those benefits may not have sufficient inducement to provide the benefits, even though the employer may not be incurring any additional cost to do so. As a result, the value of this approach to employers may be largely limited to those employers who already provide the benefits to their retired employees, even in the absence of the reduction in employer contributions.

RECOMMENDATION

Staff recommends the Board adopt the mechanism that uses contributions that otherwise would be credited to the DB Program as a means of financing health care benefits to CalSTRS members. This mechanism provides the greatest assurance that health care benefits will be provided to the greatest number of eligible retired members.

Is "Backfill" For Retiree Health Benefits a Precedent for Non-Retirement Expenditures?

SUMMARY

Using backfill for retiree health benefits should not be precedent for non-retirement expenditures because it is limited to a purpose that is explicitly approved under the Internal Revenue Code for a tax qualified retirement plan. The Internal Revenue Code explicitly allows tax qualified plans such as CalSTRS to provide retiree health benefits. Backfill would be used to comply with federal tax law to use existing CalSTRS "surplus". Backfill therefore can legitimately be limited to provide benefits allowed under the federal tax laws.

Moreover, backfill is currently being used by CalSTRS to restore benefits that otherwise would be cutback by the application of Section 415 of the Internal Revenue Code. Additionally, a number of other California public retirement systems currently use backfill to pay for retiree health benefits from their "surplus". Therefore, backfill is a well established method of providing these benefits, and has not created a precedent for non-retirement expenditures.

HOW BACKFILL WORKS

Backfill generally works as follows:

The retirement system has a "surplus" that the governing body wishes to use to pay retiree health benefits (RHBs).

Except in limited circumstances, however, the federal tax laws require that RHBs be paid for with current contributions, and that these contributions go to a walled-off portion of the CalSTRS trust fund used for RHBs only, sometimes called a "401(h) trust".

Therefore, instead of directly paying for RHBs from the existing surplus, a portion of current contributions are directed to the 401(h) trust and an equal amount of the surplus is treated as though they are current contributions to the pension portion of the CalSTRS trust.

"Backfill" therefore can be defined as the use of surplus instead of current contributions to fund pensions, when current contributions are used for another purpose that is approved by the federal tax laws for tax qualified plans.

Here is an example:

- CalSTRS has $100 surplus that it wishes to use for RHBs.

- If the tax laws were rational, CalSTRS would pay for RHBs directly with the $100.
- Instead, $100 of current contributions are directed to the 401(h) trust and the $100 of surplus is treated as if it were current contributions to CalSTRS (backfill).
- The CalSTRS trust fund is in exactly the same economic position as if it paid $100 of RHBs directly.

WHY BACKFILL IS NEEDED

Backfill is needed because of an historical anomaly.

In the early 1960's the Congress enacted limits on the amount of qualified plan assets that could be used to provide RHBs. Instead of using a direct limit such as the amount or percentage of benefits paid, Congress set the limit as a percent of contributions to the qualified plan.

In addition, this limit was reinforced recently when Congress enacted an exception to the 1960's rule and allowed, under quite limited circumstances, a direct use of surplus to pay for RHBs. We know of no public sector retirement system that has opted to use this new rule because of its restrictions.

WHY BACKFILL SHOULD NOT BE A PRECEDENT FOR USING CALSTRS' SURPLUS FOR NON-RETIREMENT EXPENDITURES

First, backfill would only be used for a purpose that is explicitly approved by the federal tax laws for a tax qualified plan as CalSTRS.

- The Internal Revenue Code explicitly allows a tax qualified plan as CalSTRS to provide RHBs.
- The IRS has approved the use of backfill in another context (see below) in a private letter ruling and has informally approved it for RHBs for public sector systems.
- Therefore, backfill can legitimately be limited to expenditures approved by the federal tax laws.

Second, backfill is already being used by both CalSTRS for another purpose – restoring benefits that otherwise would be cutback by the application of Section 415.

- This use of backfill has not created a precedent for using CalSTRS surplus for non-retirement purposes.
- In private letter ruling 200018061 (Feb. 11, 2000), the IRS recently approved the use of backfill to pay for a Section 415 replacement benefits plan.

Third, backfill has been used for a number of years by at least 6 California county and city retirement systems to provide RHBs.

- To our knowledge, the following retirement systems use their surplus along with backfill to pay for RHBs: Alameda County, Marin County, Orange County, Sacramento County, City of San Diego, and San Mateo County.
- The use of backfill has not created a precedent for using surplus for non-retirement purposes in these jurisdictions.